

# *Synopsis*

## Tax today

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*A monthly journal published by PwC South Africa providing informed commentary on current developments in the tax arena, both locally and internationally. Through analysis and comment on new law and judicial decisions of interest, it assists business executives to identify developments and trends in tax law and revenue practice that might impact their business.*



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# The capital - revenue lottery

***It happens from time to time that our Courts are seized with a matter in which a party has received a payment as consideration for its agreeing to the early termination of its rights under an agreement. The amount of such payments is frequently large, and it is not surprising that the fiscus will seek to impose income tax on such receipts.***

The question came before the Western Cape Tax Court in Case No. 11470, judgment delivered 14 March 2011. The matter concerned the payment of compensation for the early termination of the exclusive right to distribute three iconic Scotch whisky brands in Southern Africa, which had been granted to the appellant (“Limited”) at the time.

The evidence showed that in 1991, Limited had been awarded the right to distribute the Scotch whiskies for a period of 10 years within South Africa and specified neighbouring territories. The contract would be terminable after the expiration of the initial period on one year’s notice.

### ***Early termination of agreement***

Following a merger of the distiller of the whiskies and an international competitor, it became evident that the right would not be extended beyond the initial term and initial notice period and the distillers approached Limited with a proposal for the early termination of the distribution agreement. An agreement was finally reached in August 1998, in terms of which the distillers agreed to pay Limited R67 million for the early termination of the agreement which, at the time, had a further 41 months to run.

SARS sought to impose income tax on the amount received, which saw the assessment being contested by Limited, who claimed that the amount received was a receipt of a capital nature and not taxable. With the objection having been disallowed,

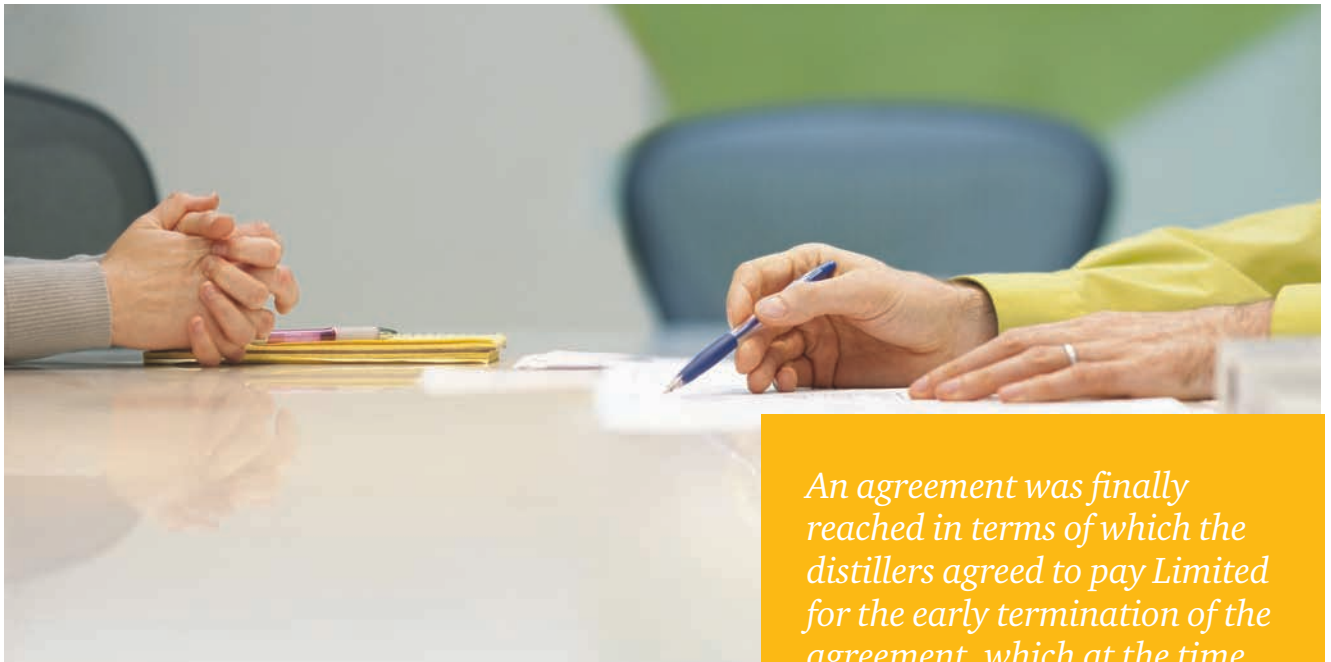
the matter came on appeal before the Tax Court.

Louw J, who presided over the appeal, encapsulated the essence of the dispute in paragraph 16 of the judgment by citing the following dictum of *Hoexter JA from Estate AG Bourke v CIR* (1991) SATC 86 at 93 – 94:

“When the receipt in question represents compensation to the taxpayer, a test which is sometimes applied is to ask the question whether the compensation was designed to fill a hole in the taxpayer’s profits, or whether it was intended to fill a hole in his assets. *Cf Burmah Steam Ship Co Ltd v Inland Revenue Commissioners* [1931] SC 156, 16 TC 67. However, as was pointed out by Broomberg *Tax Strategy* 2 ed (1983) at 199-200, the fact that what is plugged is a hole in assets does not, by itself, conclude the inquiry:

‘Of course, it is not sufficient to establish that the compensation is being paid in order to fill a hole in the taxpayer’s assets. It is necessary, in addition, to ascertain the true nature of asset in the recipient’s hands. More particularly, was the asset, prior to its destruction or damage, an asset of a capital nature or was it floating capital? If it was floating capital, such as trading stock, standing crops or consumable stores (like petrol, oil and so forth) the compensation will, obviously, be of a revenue nature, and will be subject to tax. In short, it is only where the payment received is to fill a hole in the capital assets of the taxpayer that the payment will escape the tax net.”

The matter seems to be decided for all purposes if one then considers the findings on the evidence at paragraphs 28 to 30:



*An agreement was finally reached in terms of which the distillers agreed to pay Limited for the early termination of the agreement, which at the time had a further 41 months to run.*

“[27] The rights derived from the distribution agreement did not in itself constitute part of the business carried on by Limited. Limited did not trade in the purchase and sale of rights to purchase and sell (exclusively, or otherwise) whisky. The distribution right was not trading stock in the hands of Limited and Limited could in terms of the distribution agreement, in any event, not dispose of the right.

[28] The individual purchases of Bell’s whisky from UD and the sales of the whisky to the retail trade constituted an important and lucrative part of the business activities of Limited. The exclusive right enabled Limited to sell a popular brand of whisky for as long as the right endured. It rendered the wholesale business of Limited, lucrative and yielded income and profit to Limited.

[29] The nature of the exclusive right Limited derived from the distribution agreement to sell [whisky] in South Africa is common cause. Mr. Cilliers submitted that it was a capital asset and Mr. Emslie, on behalf of the respondent, conceded that it was a capital asset in the hands of Limited.

[30] I agree that one of Limited’s capital assets was the exclusive distribution right...”

At this point one may be forgiven for concluding that the outcome is game, set and match to Limited. The Court had applied the principles enunciated at the outset. It had found that the payment was compensation for an asset and that the asset was a capital asset.

The Court, however, saw things differently. It appears to have placed considerable reliance on a passage from a UK decision, *Inland Revenue v Fleming & Co (Machinery), Ltd* (3) 33 TC at 63:

“The sum received by a commercial firm as compensation for the loss sustained by the cancellation of a trading contract or the premature cancellation of an agency agreement may in the recipient’s hands be regarded either as a capital receipt or as a trading receipt forming part of the trading profit. It may be difficult to formulate a general principle by reference to which in all cases the correct decision will be arrived at since in each case the question comes to be one of circumstance and degree. When the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the recipient’s profit-making apparatus, involving the serious dislocation of the normal commercial organisation and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilisation of a capital asset and is therefore a capital and not a revenue receipt.”

### ***Profit seriously affected***

The evidence showed that the profit of Limited was seriously affected by the cancellation of the contract, in that, in its 1999 financial year, the

profit was R38,5 million lower than in 1998 and that it declined by a further R18 million in 2000 (a decline of 44% over 2 years). The effect was so devastating that Limited was unable to negotiate rights that could generate sufficient replacement income to ensure its survival and was ultimately compelled to seek a merger with a competitor to avoid bankruptcy in 2001.

The Court, however, appeared more impressed with whether the cancellation of the agreement involved the serious dislocation of the physical business infrastructure and resulted in the cutting down of personnel. This is evident in paragraphs 24 and 25 of the judgment:

“[24] The loss of the ... distribution rights resulted in insignificant changes to Limited physical business infrastructure. But a few personnel (three to four out of 3200 employees) were laid off. [The whisky] was fully imported in bottled form and the literage of the [whisky] products sold amounted to only 1.45% of the total litreage handled by Limited. Limited’s infrastructure regarding production and distribution therefore remained virtually intact.

[25] The position was therefore that although Limited’s income-earning infrastructure remained virtually unaffected, Limited could no longer

*Whether the compensation is adequate, inadequate or excessive is not the basis for determining whether or not it is a receipt of a capital nature.*

distribute and sell, through its income-earning structure, the ... brand of products over the remaining period of the distribution right. Its existing income-earning structure was rendered less profitable, but it remained virtually unchanged and was not removed.”

The flaw in the Court’s thinking is found in paragraph 30 of the judgment. Having found that the distribution right was a capital asset, the Court stated as follows:

“The question is whether Limited was compensated for the capital value of this right, i.e. whether the compensation of R 67m paid for the early termination of the distribution right was paid as compensation for the *loss of the value* of the capital asset, the distribution right and therefore, to fill a hole in Limited’s assets, or whether it was paid as compensation for a loss of profit on the sale of the ... whiskies which would be the result of the early termination of the distribution right.” (Our emphasis)

At paragraph 38 the Court then applied this reasoning to the facts at hand:

“The evidence establishes that the amount of R67m, although it was paid for the early demise of an asset, the distribution right, it was *not calculated on the basis of the capital value* of the waning asset which was due to terminate in 41 months. Van der Watt, who testified on behalf of Limited agreed that an arms length purchaser, if it could have purchased the distribution right, would not have paid an amount equal to the future profits, including profits from other products that could be piggy-backed on the sales of [whisky] because such a purchaser would then not have had any prospect of itself making a profit. A notional purchaser would probably not have paid even R42, 177m (the net future profits from the sale of [whisky]) and far less, the R67m actually paid by [the distillers]. The amount paid was *not related to the value of the right to distribute* [whisky] for a further 41 months. The amount paid was a figure principally based on Limited’s loss of future profits from the sale of [whisky] and the other products. The amount paid sought to ‘fill a hole’ in Limited’s profits.”

With respect, whether the compensation is adequate, inadequate or excessive is not the

basis for determining whether it is or is not a receipt of a capital nature.

***The distiller had initiated the negotiation***

Our Courts have long held that disposal of a capital asset to best advantage does not render the realisation a scheme of profit making. The compensation was the result of a negotiation in which each party strove to derive the best price for itself. The compensation had not been designedly sought for by Limited. On the contrary, the distiller had initiated the negotiation for cancellation. The basis upon which Limited was able to negotiate for the best compensation was not relevant to the determination of the character of the underlying asset. The Court appears to have lost sight of the fact that it was not considering a sale to “a notional purchaser” – the distiller was seeking to terminate the rights of Limited. Had the compensation demanded been commercially unacceptable, it would not have agreed to pay that price.

The Court, however, placed reliance on how the compensation was calculated and how it was accounted for in the financial statements of Limited, this despite its conclusion, correctly it is submitted, in paragraph 32 that the method of calculation of the amount of compensation is not determinative of the nature of the receipt. The compensation was calculated principally by reference to the direct loss of profit on anticipated sales of the whiskies themselves, and to a lesser extent by reference to the loss of profit on anticipated sales of other products due to the consequential loss of influence with retailers, with an estimated R7 million being ascribed “the risk that income tax might be payable”. In the financial statements, the cash

flow statement referred to the compensation as an exceptional item under the caption “cash flow from operating activities”. In addition, Limited declared a dividend of R88 million at the end of the 1998 financial year, the funding of which was substantially the receipt of R67 million.

The Court concluded that the compensation paid “sought to ‘fill a hole’ in Limited’s profits” and that it was not of a capital nature.

***Confused logic***

It is submitted that this is a clear case of confused logic. The Court found that there had been a disposal of an asset and that the asset in question was a capital asset. However, it then held that the compensation was paid not for the loss of the asset but for loss of profit. This logical about turn is simply not supportable.

The confused nature of the Court’s decision is evident in comparing the position that it was faced with to what would have happened if the distillers had merely cancelled the agreement unilaterally without compensation.

In the alternative scenario, Limited would have retained the right to distribute the whiskies but been prevented from exercising such right. Any loss so occasioned would have been reflected in the reduction in its profits and any compensation for infringement of its right that it might subsequently have negotiated or been awarded would have been compensation for a loss of profit.

In the instant case, Limited was approached in advance to cancel or sterilise its asset. It gave up the right to derive income in the future in exchange for a consideration – it was not deprived of profits to which it was legally entitled, but rather sold the legal entitlement to derive the profits.

## Trading stock acquired for no consideration

# A taxpayer is tripped up by the parol evidence rule

*One of the reasons why tax consultancy is such a demanding profession is that it requires a high level of knowledge of disciplines entirely outside of tax, such as the principles of contract law – and sometimes, as in the Tax Court decision discussed below, the rules of the law of evidence.*

*Conversely, one of the reasons why being a contract lawyer is a demanding profession is that it requires high level knowledge of tax – and of certain rules of evidence – for if such knowledge is lacking, the contracts that the lawyer draws may have unsuspected tax pitfalls.*

*A vivid illustration of the above is to be found in the decision of the Eastern Cape Tax Court in case 12441, where judgment was given in September 2010.*

In this case, company A decided that part of its business was not generating a sufficient return, so it sold that part of its business to company B for R80 million. The agreement of sale reflected, in schedule 6 to that agreement, that the inventory relating to that part of the business had been allocated a value of nil.

Section 22(4) of the Income Tax Act 58 of 1962 provides that, where trading stock is acquired for no consideration, it is deemed to have been acquired at its market value on the date of acquisition.

Company B therefore claimed, in terms of section 22(2), a deduction of some R105 million as the market value of the trading stock acquired from Company A for no consideration.

SARS, however, did not accept that it had been acquired for no consideration.

When the matter came before the Tax Court, the primary question was whether the trading stock in question (the inventory) had indeed been acquired for no consideration.

The difficulty for Company B was that the agreement in question, apart from schedule 6 thereto which reflected a blank against the value of the inventory, contained the usual

*The parol evidence rule provides that where a document was intended to be the exclusive memorial of a juristic act, oral evidence may not be adduced to contradict that document.*

clause to the effect that, immediately prior to the effective date, there would be a stock-taking for the purpose of valuing the seller's inventory at the lower of market value and cost.

SARS argued that, ex facie the agreement itself, part of the R80 million purchase price outlaid by the taxpayer must, consequently, have been for the trading stock, which had therefore not been acquired for no consideration.

Company B tried to adduce oral evidence to the effect that the seller (Company A) had been so desperate to get rid of this part of its business that it was prepared to throw the trading stock into the deal for free, and that the trading stock had therefore been acquired for no consideration as envisaged in section 22(4).

However, the court ruled that, as a matter of law, the parol evidence rule precluded the taxpayer from adducing such oral evidence.

The parol evidence rule (which is part of our common law) provides that where a document – in this case the agreement of sale – was intended to be the exclusive memorial of a juristic act, oral evidence may not be adduced to contradict or modify that document.

The Tax Court ruled that the written agreement of sale, properly interpreted, provided that consideration was indeed given for the trading stock in question.

Consequently, section 22(4) of the Income Tax was not applicable.



## Plantation farming

# The lure of money that grows on trees

*It is easy to see the attraction of plantation farming, that is to say; establishing and tending an artificial forest to maturity, then felling the trees and selling the timber.*

*After all, farming with crops or livestock involves many risks; including disease, drought, theft and volatile markets.*

*By contrast, establishing and tending a timbered estate and selling the mature timber, seems relatively risk-free, except for the hazard of fire (which is easily insured against) and the relatively long period from planting to maturity, during which no income is produced.*

*Moreover, in contrast with many other kinds of farming, where the farmer has to rise at an ungodly hour to attend to farming chores and tramp through mud and thorn, a plantation farmer – so it may seem – hardly needs to get dirt under his fingernails.*

*Indeed, the principals in a plantation farming “partnership” are often suited, desk-bound business people, thousands of kilometers away, with no knowledge of or particular interest in the practicalities of plantation farming, but are attracted by the fiscal benefits.*

### ***The provisions of the First Schedule that deal expressly with plantation farming***

The First Schedule to the Income Tax Act contains provisions that expressly deal with plantation farming, including a definition of *plantation* (‘any artificially established tree as ordinarily understood [other than trees cultivated for fruit, oil or fibre] ... or any forest of such trees’).

The Act goes on to provide in para 15 of the First Schedule that (emphasis added)–

(1) In the determination of the taxable income of any farmer there shall be allowed as a deduction—

a) any expenditure incurred by such farmer during the year of assessment in respect of the *establishment and maintenance of plantations*; ...

b) any expenditure incurred by such farmer prior to the first day of July, 1948, in respect of the establishment and maintenance of any plantation or the *cost of acquisition of any plantation purchased by such farmer* whether before or after the first day of July, 1948: Provided that ...—

(i) *any deductions allowed under this item in respect of any plantation shall not in respect of any year of assessment exceed the gross income derived by such farmer in that year from the said plantation;*

(ii) *the aggregate of the deduction allowed in terms of this item or the corresponding provisions of the Income tax Act, 1941, or by virtue of any other provisions of the last-mentioned Act or the Income Tax Act, 1925 (Act No. 40 of 1925), in respect of plantations shall not exceed the amount of such expenditure or such cost of acquisition.*

It is implicit in the opening words of sub-section (1) and sub-paragraph (a), above, that plantation farmers are a species of ‘farmer’. From this it follows (although para 15 does not spell it out) that they are entitled to all the fiscal benefits of the First Schedule to the Income Tax Act.

Notable amongst these benefits is the right to deduct the types of capital expenditure enumerated in para 12(1) of the First Schedule, such as

the cost of eradicating invasive vegetation, installing irrigation schemes, and building access roads.

The provisions of para 15(1)(a) thus permit the deduction, not merely of expenditure on the *maintenance* of a plantation (expenditure which is inherently of a revenue nature and would in any event qualify for deduction under section 11(a)) but also its *establishment* (which is expenditure of a capital nature, and is not ordinarily deductible).

Overall, therefore, the expenditure incurred on clearing the land destined for the planting of a plantation, the expenditure incurred in the actual planting of the trees (or the cost of buying an established plantation) and building access roads is deductible.

### ***The ceiling on deductibility***

However, an important limitation on deductibility results from the wording of the proviso (i) to para 15(1)(b) and in particular from the words *any plantation* and *the said plantation*. The effect of these words is that the deductible expenditure in relation to a particular plantation is limited to the gross income derived by the farmer *from that particular plantation*.

This restriction creates problems of many kinds. Firstly, a farmer would not usually keep separate records of expenditure for each plantation – but unless he does so, he may find that none of the expenditure is deductible because he cannot bring his claim for deduction within the framework of para 15.

And anyway, how is one to decide whether a particular timbered estate consists of one or several plantations? Is a plantation that is bisected by a national road, one plantation or two? Is a timbered estate that consists of several different species of trees one

plantation or several? Is a timbered estate that straddles the boundary between two farms on separate titles one plantation or two?

The Act sheds no light on these questions, nor is there any case law on the point.

### **Farmers who operate their own sawmill**

A plantation farmer can increase his income by processing his felled trees through his own sawmill and selling the timber, not in its raw state, but as processed timber.

Assume that a plantation farmer owns his own sawmill, but conducts all his operations, including the sawmilling, in his own name or through a single legal entity.

The effect of proviso (i) to para 15(1)(b) is that his deductible expenditure from a particular plantation cannot exceed the *gross income derived by such farmer in that year from the said plantation*.

But is the amount that the farmer derives from selling the processed timber 'derived from the said plantation' or is it derived from his saw-milling operations?

If the sawmilling operations were conducted by the farmer through a separate entity, for example a close corporation in which he held a 100% members' interest, he could sell the raw timber to the sawmilling cc, and the selling price would clearly be *gross income derived from the plantation*, as envisaged in proviso (i) to para 15(1)(b).

But if the plantation farming and the sawmilling are conducted by the farmer in his own name, or in the same legal entity, there seems to be no possibility of assigning a notional selling price to the raw timber at the point where it is delivered to the sawmill.

Our income tax system does not operate on the basis of 'notional' income or 'notional' expenditure, save where the Act specifically provides otherwise. On the facts outlined in the previous paragraph, the only 'gross income' that was derived was the price paid by the



***A timber farmer must keep separate records of expenditure in relation to each plantation.***

outside party who bought the timber after it had gone through the sawmill.

In *Natal Estates Ltd v CIR* 1975 (4) SA 177 (A), 37 SATC 193 the Appellate Division rejected the argument that the taxpayer should be allowed to claim, as a deduction, the notional value of land at the juncture when it ceased to be used for farming and commenced being used in a trade of property development.

Where a plantation farmer processes timber from his plantation through his own sawmill and then sells the processed timber, but does not house the saw-milling operations in a separate entity, the application of proviso (i) to para 15(1)(b) seems to lead to one of two possible conclusions:

the full amount derived from the sale of the processed timber constitutes *the gross income derived by such farmer from the said plantation* as envisaged in that proviso, with the result that he can claim deductible expenditure for the *establishment and maintenance* of the plantation up to that ceiling amount; the premise of this interpretation is that processing the raw timber through a saw-mill does not deprive the subsequent selling price of its character as *income derived from the plantation*.

The alternative conclusion is that—

the *gross income derived by such farmer from the said plantation* is zero because, on these facts, no

income was *derived from the said plantation* and all the income was derived from the separate activity of 'saw-milling operations'.

The corollary of the latter interpretation is that proviso (i) to paragraph 15(1)(b) would then bar the taxpayer from claiming a deduction for any expenditure at all in respect of the 'establishment and maintenance of the plantation'; he would be taxed on the gross selling price of the processed timber, and all that he could deduct would be the expenditure associated with the sawmill. It is arguable that this is a result so absurd that the legislature could not have intended it.

### **Tax planning considerations**

The tax-planning moral of all this pedantry is that —

a timber farmer should be aware of the fact that he must keep separate records of expenditure in relation to each plantation. If he is in doubt as to whether his timbered estate consists of one plantation or several, he should either keep his records on the assumption that they are separate plantations, or else he should seek a binding private ruling from SARS on this point;

if a plantation farmer operates his own sawmill, he should house the sawmilling operations in a separate legal entity from the farming operations, such as a close corporation, and he should sell the raw timber to that separate entity at its market value in the raw state.

## Interpretation note 3 (issue 3) - Limitation of deductions for employees and office holders

*Interpretation note 13 (issue 3) of 15 March 2011 has been issued in order to clarify the deductions that are claimable by employees and office-holders.*

In this regard, relevant amendments were made by the Revenue Laws Amendment Act 60 of 2008 which introduced sections 11(nA) and (nB)

The latter two provisions permit a deduction of amounts included in taxable income in respect of services rendered or the holding of any office or in respect of restraint of trade, where these amounts were later refunded by the recipient.

The Interpretation Note says that – Section 23(m) was introduced to limit the deductions that may be claimed by employees and office holders against their employment income. The limitation excludes agents and representatives whose remuneration is normally derived mainly in the form of commission based on sales or turnover attributable to that agents or representatives. Section 23(m) has been periodically updated to expand the deductions that employees and office holders may claim. The most recent amendment provides that, if certain amounts were received by or accrued to an employee and were included in the employees' taxable income, where any portion of that amount is refunded by the employee to the employer, the refunded amount will be allowed as a deduction against the employee's taxable income. The same principle applies to restraint of trade payments that were previously included in taxable income, and were subsequently refunded by the employee.

If this bland recital had been more forthright, it might have conceded that section 23(m) is a thoroughly discreditable provision whose objective is to maximise tax revenues by an unprincipled denial of bona fide section 11(a) deductions to SARS's most valuable tax base – the broad mass of fiscally naive wage and salary earners.

If this unpleasant aspect of section 23(m) is disregarded, the Interpretation Note is a valuable reminder of the tightness of the fiscal straitjacket that imprisons this class of taxpayer, whilst highlighting the few respects in which the straitjacket is relaxed.

Thus, the Interpretation Note concedes that the term "employment" in the context of section 23(m) – should be afforded its narrower meaning of an employer-employee (master servant) relationship. An independent contractor is therefore not affected by the prohibition on deductions.

Many taxpayers are in salaried employment (whether full or part-time) and simultaneously carry on a business for their own account, entirely separately from that employment.

The Interpretation Note gives a worked example ("Example B") in relation to such a taxpayer, showing which expenses are deductible and non-deductible in relation to the employment income and which are deductible in relation to the independent trade. The example makes the useful point that a bad debt arising from employment (eg unpaid salary due by a liquidated employer) is deductible against employment income, but that cellphone airtime expenses are not.

The Interpretation Note points out that an agent or representative whose remuneration is *normally* derived *mainly* in the form of commission based on sales or turnover is excluded from the ambit of section 23(m), and goes on to say that *mainly* is interpreted to mean more than 50% of gross remuneration while *normally* is based on a subjective test,

in which each case must be evaluated on its own merits "with due regard to the taxpayer's previous and future years of assessment".

The reference to "future years of assessment" presumably refers to what may reasonably be expected in future years. The Interpretation Note does not venture a view on how a taxpayer would be assessed, where he or she had just commenced a job involving salary and commission, where the commission will be less than the fixed salary in the first years, but may reasonably be expected to exceed salary as the agent gains in experience. Over what period must the *normal* commission be adjudged?

Clearly, the period must extend beyond the first year of assessment in the job, or else the word *normally* would be meaningless and *mainly* would be the sole criterion.

The Interpretation Note makes the further useful point that where the commission is more than 50% of gross remuneration, the agent or representative may qualify for deductions under section 11 – as is illustrated in examples C, D, E and F in the Interpretation Note.

The Interpretation Note suggests that, in this context, *agent* should mean a person authorized or delegated to transact business for another, and that *representative* should mean one who represents another or others. The suggested interpretation seems sensible as encapsulating the requirement that the person in question must be selling or purchasing, not on his own behalf, but on behalf of an employer.